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IN THE

Supreme Court of the United States

OCTOBER TERM, 1988

COLONIAL AMERICAN LIFE INSURANCE COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE FIFTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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To resolve the issue in this case, the Court must decide whether indemnity reinsurance is treated by the Internal Revenue Code (the "Code") as the issuance of insurance or as the acquisition of an asset. Under the taxing pattern prescribed in Part I of Subchapter L of the Code, life insurance companies typically incur underwriting losses on newly issued insurance in the year such insurance is issued. Such losses occur because the reserves required and expenses incurred in issuing insurance generally exceed

the total premiums received in that year.[1] Although the Commissioner readily acknowledges that issuers of directly-written insurance should deduct in the year incurred the expenses of issuing such insurance, he argues that the taxing pattern prescribed by Part I of Subchapter L does not apply to the type of insurance known as indemnity reinsurance.

The Commissioner's position is premised upon his contention that a life insurance company purchases an intangible asset ("a future stream of income") when it issues indemnity reinsurance and that the ceding commission is incurred to acquire that asset. From this premise, the Commissioner argues that, under so-called "general" or "fundamental" tax principles which apply to "any other taxpayer, in any other setting,"[2] the ceding commission incurred in issuing indemnity reinsurance must be capitalized and amortized.

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[1] Underwriting gains generally will occur after the year in which the insurance is issued only if the premiums charged are in excess of the amounts ultimately required to meet claims and expenses. Because of the long-term nature of insurance, this can be determined only after the insurance is terminated as a result of a claim, surrender, or lapse. *See* S. Rep. No. 291, 86th Cong., 1st Sess. 6-7, *reprinted in* 1959 U.S. Code Cong. & Admin. News 1575, 1581.

[2] Brief for the Respondent ("Comm. Br.") at 7. The "general" principles relied upon by the Commissioner are not as well-settled as he would have this Court believe. *See, e.g.*, 1 B. Bittker, *Federal Taxation of Income, Estates and Gifts* ¶ 20.4 at 20-65 through 20-102 (1981), cited by the Commissioner (Comm. Br. at 16, 32, 39), which describes numerous types of expenditures that taxpayers are authorized to deduct currently although they result in benefits being received beyond the taxable year.

Petitioner, Colonial American Life Insurance Company ("Colonial"), is *not* "any other taxpayer, in any other setting," and indemnity reinsurance is not, and is not taxed as, the acquisition of an asset. During the years in issue, Colonial was a life insurance company issuing insurance in the form of directly-written insurance and indemnity reinsurance and was subject to taxation under the special provisions of Part I of Subchapter L applicable to such transactions.

I.

The Commissioner refuses to acknowledge that Congress treated indemnity reinsurance as the issuance of insurance in Part I of Subchapter L. Instead, he focuses solely on the expectation of an indemnity reinsurer that it will receive future premium income in consideration for the insurance coverage it provides. He then asserts that the issuer of indemnity reinsurance acquires an intangible asset, *i.e.*, "a future income stream," at the time it issues its reinsurance contract.[3]

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[3] According to the Commissioner, since the purchasing company also acquires "a future income stream" in an assumption reinsurance transaction, the ceding commission incurred in issuing indemnity reinsurance should be treated in the same manner as the amount paid to acquire insurance policies in an assumption reinsurance transaction. In fact, the tax treatment prescribed by Treas. Reg. § 1.817-4(d)(2)(ii) for the amount paid to buy insurance policies in an assumption reinsurance transaction is different from the "acquisition of an asset" approach urged by the Commissioner for ceding commissions in indemnity reinsurance transactions. That regulation adopts a "deferred expense" approach for the amount paid in an assumption reinsurance transaction that is controlled by section 809(d)(12) and *section 162*. The Commissioner argues here for an "acquisition

It is no more correct to isolate and focus on only one aspect of indemnity reinsurance (*viz.*, the expectation by the insurer of receiving future premium income in consideration for the insurance it provides) in order to resolve the issue presented here than it is to isolate and focus on only that same aspect of directly-written insurance in order to determine the tax treatment of agents' commissions and other expenses incurred in issuing that insurance.[4] In the case of both directly-written insurance and indemnity reinsurance the insurer has incurred expenses in issuing the insurance and expects to receive future premium income from its policyholder in consideration for its insurance coverage. Those facts certainly could not be determinative of the tax treatment of the expenses so incurred. Otherwise, the Commissioner could not agree—as he always has—that the expenses of issuing directly-written insurance are currently deductible.

What is determinative is that both directly-written insurance and indemnity reinsurance are treated by the tax law *solely* as the issuance of insurance, and *not* as the acquisition of an asset, and in each case the expenses incurred by the issuing company are treated *solely* as incurred in issuing such insurance, and *not* in acquiring an asset.[5] Accordingly, such ex-

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of an asset" approach that is controlled by section 809(d)(12) and *section 167* (Comm. Br. at 11).

[4] Obviously, insurance companies insist on receiving future premium income in return for agreeing to share any losses from specified risks. They also expect to make a profit, although that expectation is not necessarily realized.

[5] The cases relied on by the Commissioner (Comm. Br. at 16-20), which require capitalization and amortization of acquisition expenses, including amounts paid by insurance companies to pur-

penses are deductible when incurred under the taxing pattern prescribed in Part I of Subchapter L. In the case of indemnity reinsurance, section 809(c)(1) mandates this result for ceding commissions and implements the clearly articulated intent of Congress that an indemnity reinsurer be "treated substantially in the manner he would be if he had issued the [rein-

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chase insurance contracts from other insurance companies in assumption reinsurance transactions, are inapposite to the present case. The Tax Court and the Seventh Circuit so concluded when the Commissioner relied on many of the same cases to support his position before those courts. As the Tax Court observed:

> Respondent [the Commissioner] cites to us numerous cases which require capitalization and amortization of acquisition expenses. However, *such cases apply when an asset is acquired, not when insurance is sold. Although a reinsuring company does acquire an asset in a broad sense in the form of potential future profit, such is also true when an insurance company issues a single policy to an individual. Yet, the expenses relating to that policy are currently deductible.* While respondent's argument is appealing, it does not comport with how life insurance companies are taxed with respect to insurance they issue. *In essence, respondent argues indemnity reinsurance should be taxed as is assumption reinsurance; yet, the Code treats one* [*indemnity reinsurance*] *as the issuance of insurance and one* [*assumption reinsurance*] *as* [*the*] *acquisition of an asset. That makes all the difference.*

Beneficial Life Insurance Co. v. Commissioner, 79 T.C. 627, 647-48 (1982) (emphasis added). *See also Merit Life Insurance Co. v. Commissioner*, 853 F.2d 1435, 1441-43 (7th Cir. 1988), *aff'g* 52 T.C.M. (CCH) 658 (1986), *petition for cert. pending*, No. 88-955.

sured] insurance policy (or part thereof) directly." S. Rep. No. 291, *supra*, at 38-39, 1959 U.S. Code Cong. & Admin. News at 1613-14.

The Commissioner evidently does not like this result. Thus, in advancing his position, he disregards the fact that indemnity reinsurance and directly-written insurance are inherently the same and that Congress treated both as the issuance of insurance in Part I of Subchapter L. The Commissioner also dismisses the differences between indemnity reinsurance and assumption reinsurance as irrelevant. Those differences, however, are fundamental, substantive differences that are recognized by the federal income tax law.[6] The tax law treats indemnity reinsurance, like directly-written insurance, as a continuing insurance relationship between the company issuing the insurance (the reinsurer) and its policyholder (the ceding company). In contrast, the tax law treats an assumption reinsurance transaction as a purchase by an insurance company of insurance contracts from another insurance company.[7]

The Commissioner's refusal to acknowledge this

[6] Those differences are also recognized by the law governing insurance. The Commissioner is wrong in characterizing them as mere "differences in duration and form." Brief for the Petitioner ("Pet. Br.") at 2-4, 10-21.

[7] In contrast to the tax treatment of the expenses of issuing indemnity reinsurance and directly-written insurance, Treas. Reg. § 1.817-4(d)(2)(ii) requires the amount paid to acquire insurance contracts in an assumption reinsurance transaction to be treated as a "deferred expense" to be deducted over the useful life of the contracts acquired.

treatment by the Code appears to be based largely on his belief that the current deduction of ceding commissions incurred in issuing indemnity reinsurance would be an "extraordinary" result (Comm. Br. at 35) and would "grossly distort" (Comm. Br. at 8, 17) income by "mismatching" income to be received in the future and the costs of acquiring that income.[8] The Commissioner never explains why the current deduction of a selling expense in respect of indemnity reinsurance should be considered as "extraordinary" or as resulting in a "gross distortion" of income, when he acknowledges that such a deduction is obtained in respect of directly-written insurance. No sound explanation can be given. In both cases Part I of Subchapter L allows a life insurance company to reduce currently its underwriting income by the expenses incurred in issuing its insurance.

II.

The Commissioner insists that, in order to override the "tax principles generally applicable to all other

[8] The Commissioner also complains (Comm. Br. at 42) that the result urged by Colonial would invite "abuses" because it would result in underwriting losses in the year the indemnity reinsurance is issued and may encourage insurance companies to use indemnity reinsurance "to defer taxation indefinitely on *all* of their underwriting gains" (emphasis in original). That complaint ignores the taxing pattern of Part I of Subchapter L and disregards the fact that indemnity reinsurance is essential to the ability of the insurance industry to control risks effectively. It also erroneously assumes, contrary to the testimony of Colonial's expert witness (Tr. at 58-60), that indemnity reinsurers (as well as direct insurers against which logically the same complaint could lie) have an infinite amount of surplus to support mounting losses that is unregulated by state insurance authorities and that is available to them to play a "shell game."

taxpayers," specific language in Part I of Subchapter L, the regulations, or the legislative history permitting the current deduction of ceding commissions incurred in issuing indemnity insurance would be required. The Commissioner has it backwards. The taxing pattern of Part I of Subchapter L, and *not* "tax principles generally applicable to all other taxpayers," applies here. That taxing pattern requires that expenses incurred in issuing insurance be deducted currently. Therefore, specific language in the Code would be required in order to reach the contrary result urged by the Commissioner in this case.

A.

There is, however, specific language in a provision in Part I of Subchapter L—section 809(c)(1)—which allows a life insurance company to deduct currently ceding commissions it incurs in issuing indemnity reinsurance. Section 809(c)(1) expressly provides that "return premiums" and "premiums and other consideration arising out of reinsurance ceded" are to be deducted from the gross amount of premium income determined under that section. Section 1.809-4(a)(1)(ii) of the Treasury Regulations expressly provides that "amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded shall be included in return premiums." Ceding commissions incurred in issuing indemnity reinsurance are "amounts of premiums or other consideration returned to another life insurance company in respect of reinsurance ceded." The fact that such commissions are incurred simultaneously with the receipt of a premium from the ceding company makes them no less a "return premium" than

if they were incurred at a later point in time. Contrary to the Commissioner's contention, there is absolutely nothing in the statute, the regulations thereunder, or the relevant legislative history that limits the definition of "return premiums" in the case of indemnity reinsurance *solely* to experience refunds.[9]

A few years after the Tax Court decided *Beneficial Life*, Congress enacted extensive revisions to Part I of Subchapter L.[10] Those revisions did not alter the substance of section 809(c)(1) insofar as it pertains to the treatment of ceding commissions incurred in issuing indemnity reinsurance.[11] If Congress had been

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[9] The fact that the legislative history of section 820, referred to by the Commissioner (Comm. Br. at 31), contains the statement that experience refunds under indemnity reinsurance are to be excluded from premium income in no way supports his view that this is the *only* situation in which amounts of premiums or other consideration returned to another life insurance company in respect of indemnity reinsurance reduce premiums. Indeed, the legislative history of section 809(c)(1) refutes any such suggestion. Thus, the Senate Finance Committee Report provides that "return premiums or other consideration returned to another life insurance company under an indemnity reinsurance contract" are to be included in "return premiums." S. Rep. No. 291, *supra*, at 54, 1959 U.S. Code Cong. & Admin. News at 1629.

Furthermore, there is no support in the statute for the Commissioner's view that the phrase "premiums and other consideration arising out of reinsurance ceded," which appears in section 809(c)(1), applies *solely* to ceding companies (and not to reinsurers) in indemnity reinsurance transactions.

[10] Deficit Reduction Act of 1984 ("DEFRA"), Pub. L. No. 98-369, § 211, 98 Stat. 494, 720.

[11] Nor did those revisions alter the substance of section

concerned that the Tax Court misinterpreted section 809(c)(1) as it applies to such ceding commissions, it could have legislated a different result. Congress chose not to do so.

B.

Ceding commissions and other expenses incurred in issuing indemnity reinsurance are deductible currently under sections 809(d)(12) and 162, just as agents' commissions and other expenses incurred in issuing directly-written insurance are deductible currently under those provisions. The Commissioner disagrees (Comm. Br. at 36-38) and contends that any analogy between ceding commissions incurred in issuing indemnity reinsurance and agents' commissions incurred in issuing directly-written insurance is a "false analogy."[12]

809(d)(12) or section 818(a) as they pertain to the issue in this case. The successors to sections 809(c)(1), 809(d)(12), and 818(a) that were enacted by DEFRA are found in sections 803, 805(a)(8), and 811(a) of the Internal Revenue Code of 1986 now in effect.

[12] The Commissioner suggests that somehow there is a "false analogy" because of the number of parties involved in each transaction: in indemnity reinsurance there are typically two parties to the transaction (the issuer of the insurance and the company to which the insurance is issued), whereas in directly-written insurance there are typically three parties (the issuer of the insurance, the person to whom the insurance is issued, and a sales agent). In fact, the indemnity reinsurance in this case involved three parties: the issuer of the insurance, the company to which the insurance was issued, and a sales agent to which a finder's fee that is also at issue here was paid. This fact has not affected the Commissioner's position that the finder's fee is not currently deductible. Moreover, having acknowledged that an agent's commission is deductible currently where a third party purchases an insurance policy, surely the Commissioner would not suggest that, where an agent purchases an insurance policy

That contention is unfounded and has been specifically rejected by the Tax Court and by the Seventh Circuit. Indeed, the United States Court of Claims also had occasion to observe:

> When plaintiff [the ceding company] reinsured [in an indemnity reinsurance transaction] the business with North America [the reinsurer] it took on, as between it and North America, the character of agent, and as such it was entitled to a commission on the amount reinsured with North America.

Colonial Surety Co. v. United States, 178 F. Supp. 600, 602 (Ct. Cl. 1959).[13]

The Commissioner states that section 809(d)(12) "embraces only the usual range of 'ordinary and nec-

for himself (*i.e.*, where only *two* parties are involved), the agent's commission paid to him would not be deductible currently. The point is that the number of parties involved in indemnity reinsurance and in directly-written insurance has nothing to do with determining the tax treatment of the expenses of issuing each type of insurance.

[13] The Commissioner also asserts that the fact that agents' commissions are compensation income to the sales agents for selling directly-written insurance on behalf of insurance companies somehow determines the timing of the deduction by the direct insurer for such commissions. Implicit in this assertion is the erroneous premise that the timing of the deduction of an amount by the payor is controlled by the nature of that amount to the recipient. This assertion also disregards the fact that the ceding company must take into income the full amount of the ceding commission in the year the indemnity reinsurance is issued.

essary' deductions, and that provision in no way comprehends the capital payments embodied in a ceding commission."[14] This statement is inconsistent with Treas. Reg. § 1.817-4(d)(2)(ii) which makes it quite clear that the amount paid to acquire insurance contracts in an assumption reinsurance transaction, *to the extent it is an "ordinary and necessary" business expense*, must be treated as a "deferred expense," a portion of which is allowed as a deduction under sections 809(d)(12) and 162 over the reasonably estimated life of the contracts acquired.[15] Certainly, if the amount paid to acquire insurance policies in an assumption reinsurance transaction can constitute an "ordinary and necessary" business expense under the Commissioner's own regulations, albeit one that must be deferred, the Commissioner cannot seriously contend here that the ceding commission incurred in issuing indemnity reinsurance cannot also constitute an "ordinary and necessary" business expense, albeit one that must be deducted in full currently.[16]

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[14] Comm. Br. at 9.

[15] To our knowledge, the Commissioner has never previously contended, in contradiction of his own regulation, that the amount paid by the purchasing company in an assumption reinsurance transaction for the acquisition of insurance contracts (to the extent such amount is paid for the insurance contracts and not for assets such as goodwill that have no determinable useful life) is other than an "ordinary and necessary" business expense which must be treated as a "deferred expense" under sections 809(d)(12) and 162.

[16] Indemnity reinsurance is an integral part of the day-to-day business of the insurance industry (*see, e.g.*, Tr. at 27 and Brief for the *Amici Curiae* in Support of Petitioner at 4-10) and the ceding commission incurred in issuing indemnity reinsurance is nothing more than a normal, routine expense incurred by an

C.

The Commissioner would have this Court believe that there is a rule of "accrual accounting" which requires a life insurance company to capitalize ceding commissions incurred in issuing indemnity reinsurance and that therefore section 818(a) does not require the application of NAIC accounting in the present case (Comm. Br. at 10, 38-39).[17] The Commissioner is wrong.

The Commissioner is also wrong in contending that the rule requiring "acquisition costs of a future benefit" to be capitalized is a rule of "accrual accounting." Moreover, his reliance on Treas. Reg. § 1.461-1(a)(2) as support for his contention is misleading. The requirement to classify an expenditure as a currently deductible expense or as a capital item is *not* a rule imposed by "accrual accounting." It is a requirement imposed by Treas. Reg. § 1.446-1(a)(4)(ii) and is not dependent on the particular accounting method a taxpayer uses. This requirement exists regardless of

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indemnity reinsurer in issuing its insurance to another insurance company.

[17] The Commissioner also contends (Comm. Br. at 40 n.29) that Colonial's NAIC accounting argument—

> ultimately proves too much, for the NAIC procedures on which it relies appear equally to require a first-year write off, not only of ceding commissions paid in indemnity reinsurance, but also of those paid in assumption reinsurance as well . . . .

Apparently the Commissioner has ignored the fact that a specific provision in his own regulations overrides NAIC accounting regarding assumption reinsurance transactions. That is a critical distinction under section 818(a).

whether a taxpayer is on the accrual method of accounting, the cash method of accounting, or any other method of accounting. It is restated not only in the regulation applicable to accrual method taxpayers that is cited and quoted by the Commissioner (Treas. Reg. § 1.461-1(a)(2)), but also in the regulation applicable to cash method taxpayers (Treas. Reg. § 1.461-1(a)(1)) that is *not* cited or quoted by the Commissioner.

Thus, both Treas. Reg. § 1.461-1(a)(1) (applicable to cash method taxpayers) and Treas. Reg. § 1.461-1(a)(2) (applicable to accrual method taxpayers) refer, in virtually identical terms, to the requirement imposed by Treas. Reg. § 1.446-1(a)(4)(ii) that any expenditure resulting in the creation of an asset having a useful life which extends substantially beyond the close of the taxable year may not be deductible, or may be deductible only in part, for the taxable year in which incurred. The Commissioner's suggestion that the reference to this requirement in the regulation applicable to accrual method taxpayers (Treas. Reg. § 1.461-1(a)(2)) means that such a requirement is a rule imposed by the accrual method of accounting, which must therefore override NAIC accounting, is baseless.

Moreover, this case does not involve "acquisition costs of a future benefit," as the Commissioner asserts. It involves the issuance of indemnity reinsurance and the tax treatment of ceding commissions incurred in issuing that insurance. The rules of accrual accounting do not speak to the question of the character, as a currently deductible expense or as an amortizable capital expenditure, of those ceding commissions.[18] Accordingly, section 818(a) requires NAIC

[18] Nor do accrual accounting rules address the character, as a currently deductible expense or as an amortizable capital expenditure, of the commissions and other expenses incurred in issuing directly-written insurance. The Commissioner concedes this point when he acknowledges that such expenses are deductible currently. Thus, there is no logical basis for the Commissioner to assert here that accrual accounting rules require the capitalization of ceding commissions incurred in issuing indemnity reinsurance.

accounting to control the federal tax treatment in the present case.[19]

The Commissioner also is wrong and misleading in claiming (Comm. Br. at 18, 41) support for his position in *The Industry Audit Guide of Stock Life Insurance Companies* (1972) (the "Audit Guide").[20] The Audit Guide prescribes generally accepted accounting principles ("GAAP") for stock (not mutual) life insurance companies which are utilized to produce financial statements which fairly present the financial condition of the business enterprise. Because GAAP requires ceding commissions incurred in issuing indemnity reinsurance and amounts paid in assumption reinsurance transactions to be treated in the same manner (*viz.*, to be capitalized and amortized), the Commissioner would like this Court to conclude that, for federal income tax purposes, there is no distinction between indemnity reinsurance and assumption reinsurance or between the treatment of such commissions and such amounts. He fails to point out that GAAP also requires agents' commissions and other

[19] Pet. Br. at 26-30.

[20] The Audit Guide was prepared by the Committee on Insurance Accounting and Auditing of the American Institute of Certified Public Accountants "to provide guidance to independent auditors in examining and reporting on financial statements of life insurance companies" (Audit Guide at 1).

expenses incurred in issuing directly-written insurance to be capitalized and not deducted currently (*Id.* at 71-74). The Commissioner does not contend that the federal income tax treatment of such expenses is governed by GAAP. This is because GAAP does not control the tax treatment of expenses incurred in issuing directly-written insurance any more than GAAP controls the tax treatment of ceding commissions incurred in issuing indemnity reinsurance.[21]

This Court, which has previously recognized that "[l]ife insurance accounting is a world unto itself" and that "mechanical application of ordinary accounting principles will not necessarily yield a sound result,"[22] should not countenance the Commissioner's disregard of the provisions of Part I of Subchapter L which are based on NAIC accounting. Resort to some purported "general" or "fundamental" tax rule that may be applicable to "any other taxpayer, in any other setting" to determine the federal income tax treatment of ceding commissions incurred in issuing indemnity reinsurance would yield an unsound result

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[21] *See* Audit Guide at 65. In fact, Appendix C of the Audit Guide, which specifically concerns deferred income taxes, notes that one of the most significant timing differences between GAAP and the federal income tax rules applicable to insurance companies results from the deferral and amortization under GAAP of various costs they incur, such as the expenses of issuing directly-written insurance and indemnity reinsurance (*Id.* at 152).

[22] *United States v. Consumer Life Insurance Co.*, 430 U.S. 725, 739 n.18 (1977). *See also Beneficial Life*, 79 T.C. at 647 ("An understanding of that difference [between the tax consequences of indemnity reinsurance and assumption reinsurance] must flow from the understanding of the complex and somewhat unique rules applicable to the insurance industry.").

contrary to Part I of Subchapter L, its legislative history, and the regulations thereunder.

For these reasons and those set forth in our opening brief, the judgment of the court of appeals should be reversed, and the case should be remanded with instructions to affirm the Tax Court's judgment.

Respectfully submitted,

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